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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941

No. 151

UNITED STATES OF AMERICA,
Petitioner,

vs.

JOLIET & CHICAGO RAILROAD COMPANY,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT

SILAS H. STRAWN,
FRANK H. TOWNER,
EDWARD G. INCE,
ARTHUR D. WELTON, JR.,
Attorneys for Respondent.

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BRIEF FOR RESPONDENT

The sole reason advanced for granting the writ is an alleged conflict *in principle* between the court below and the cited decisions of other Circuit Courts of Appeals.

There is no conflict of decision. The petition does not and cannot show that, in its necessary effect, the decision below stands for a rule conflicting with the decisions cited. This could not be shown, because they are not conflicting decisions as to the same matter. There is nothing to indicate that the court below would not, in an appropriate case, follow the cases cited by peti-

tioner. On the face of the petition, there is no reason for granting the writ.

There can be no conflict in principle between courts whose *ultimate* criterion is the presence or absence of control over or interest in the income to be taxed or the property producing it.

The petition fails fully or accurately to present the reasoning of the decisions allegedly conflicting, and it fails fully to present the circumstances distinguishing this case from those establishing the "constructive receipt" doctrine upon which petitioner relies. Proper consideration of these matters demonstrates conclusively that there is no conflict in principle, just as there is no conflict in decision.

An attempted impression (Pet. p. 5) is that there should be no distinction in the applicable rule based merely on the length of the term of a lease. That seems correct, but has nothing to do with this case. As in mathematics, infinity carries consequences beyond the finite, however great the finite may be. A lease in perpetuity, without defeasance clause, involves legal and economic consequences unknown to a lease for a term, however long.

The first and foremost consequence is that it is not a lease at all, but a conveyance; hence the relation of landlord and tenant does not exist. Thus, the primary basis of the decisions relied upon by petitioner is found wanting in this case, for in each of those cases the right of reentry for breach of the lease remained in the lessor corporation, and the payments received by its stockholders represented earnings of the property *owned by their corporation*. That is not so in the case at bar.

Petitioner seeks to avoid the effect of this circumstance by asserting it to be a distinction without substance, and by claiming that it only changes the char-

acter of the payments from rent to payments of purchase money, or of ground rent. In either of those events, states the petition, they are as much income as though ordinary rent "since there was no proof offered, or contention made, that they did not represent a profit." (Pet. p. 6.)

To this it may be said, first, that the argument is not advanced by putting a different label on the payments involved, and second, that there could have been no object in offering proof as to an issue not raised. Petitioner's position has been consistently based on Article 70 of Regulations 74 (and similar subsequent regulations) (Pet. p. 9) which refer only to payments "in lieu of other rental." These points, however, need not be labored, because the question here is not whether the payments involved were income, but *whose* income they were.

Petitioner contends that there is no tax significance in the fact "that in one case the obligation arises out of a lessor-lessee relationship, and in the other out of a vendor-vendee relationship." (Pet. p. 6.) This is unsound because the question is not what the relationship is called but, what are the legal and economic incidents of the relationship. In the lessor-lessee relationship the courts have found a basis for tax liability against the lessor in the fact of ownership in the lessor of the property producing the income that finds its way into the hands of the lessor's stockholders. Where the vendor-vendee relationship exists this necessary chain of circumstances is absent.

It is not conceded that the relationship of vendor and vendee exists in the case at bar. It may be that the transaction of 1864 was a sale but if so it was a completed transaction at that time. The indenture then entered into effectively divested this respondent of all

interest in the payments to its stockholders, and with equal effectiveness vested those rights in the stockholders. Therefore, if it was a sale there was a complete and irrevocable assignment of the consideration in 1864. That fact cannot give rise to income tax liability against the assignor at the present time.

In the cases involving the lessor-lessee relationship, the courts have indicated clearly that they would be controlled by the effect of such an assignment, and hold the lessor not liable to income tax, were it not for the continuing ownership of the underlying fee to the leased property in the lessor, with the resulting chain of circumstances already referred to. All that the court below did was to follow the cases relied on by petitioner in so far as they were applicable, but to stop short of the conclusion of tax liability reached in those cases; because under the circumstances in this case the chain of circumstances upon which that liability is predicated is conspicuously absent. The decision is clearly right.

Petitioner contends, nevertheless, that simply because the payments are income it follows, under the decisions relied on by petitioner, that they were income constructively received by this respondent, and, therefore, taxable to it. This conclusion *might* follow if the principle of those decisions were as stated by the petition; or if the actual principle of the decisions were applicable in the circumstances of this case. It must, however, be rejected on both grounds.

To sustain its contention that there is a conflict in principle, petitioner asserts that in each of the cases cited the taxpayer was held to have realized income by way of constructive receipt, "because the payments to its stockholders were in discharge of an obligation owing to the taxpayer by the lessee and were thus made on the taxpayer's behalf." (Pet. p. 6.) Continuing, the

petition states: "By the same reasoning, the respondent here realized income because the payments to its stockholders were in discharge of an obligation owing to it by the lessee [*sic*] and were thus made on its behalf."

In this statement and suggested application of principle, the petitioner has indulged in two errors.

In the first place, the actual basis of each of the decisions is not susceptible of the simple statement advanced by petitioner: different circumstances in each case resulted in different emphasis, and only as to some of the cases can it be said that the conclusion was spelled out as petitioner suggests. Furthermore, petitioner's manner of statement practically begs the question by omitting the reason why the courts thought an obligation existed—an omission of which the courts were not guilty. That reason—existence of the lessor-lessee relationship—was the real ground of the decisions relied upon.

In the second place, petitioner overlooks the fact that in the case at bar there is neither any such obligation, nor any basis for it.

The obligation referred to is the obligation to make payments for the use of leased property in order to be entitled to such use. Such an obligation existed in each of the cases cited by the petitioner, and in each, enforcement of that obligation was sanctioned by rights of forfeiture and reentry in the lessor corporation. It was thus apparent in those cases that the lessor corporation was the owner of the property producing the income paid directly by its lessee to its stockholders. This set of circumstances is the common denominator of the constructive receipt cases, as a brief review will demonstrate.

In the *Blalock case* (246 Fed. 387; C. C. A. 5th), the court held that payment to another at the direction of a creditor (the lessor) was the same as payment to the

creditor, and that there was no difference between receipt by the corporation itself "of net income accruing from *its business or property*" (p. 390), and receipt thereof by its stockholders directly.

In the *West End Street Railway case* (246 Fed. 625; C. C. A. 1st) the court noted that the payments to the stockholders "were made by the lessee for its use of the corporation's property" (p. 626) pursuant to agreement between the lessee and "the lessor corporation *to which the property belongs*" (p. 626), the payments being expressly designated "as part of the agreed rent for the property" (p. 627). The court thought, further, that the agreed payments could certainly be recovered by the lessor, but that it was "at least uncertain" whether the stockholders could collect in their own right.

In the *Rensselaer case* (249 Fed. 726; C. C. A. 2nd), the "dividends" were also stated to be part of the rent paid for the use of the property, and, under the terms of the lease there involved, the court said that "the rent is a debt of the lessee to the lessor" (p. 727), and, therefore, the payments to the lessor's stockholders were made by the lessee "as agent of the lessor" (p. 728). The case of *Northern Railroad Co. of N. J.* v. *Lowe* (250 Fed. 856; C. C. A. 2d), was merely a *per curiam* decision, without opinion, on authority of the *Rensselaer* case.

In *American Telegraph & Cable Co.* v. *U. S.* (61 C. Cls. 326), the court held the payments to be of "rent, due primarily to the lessor, *for its property,* in which the stockholders have no direct ownership" (p. 333), and noted that on failure of the lessee to pay, the lessor "would have its legal remedies" (p. 333).

Harwood v. *Eaton* (68 F.(2d) 12; C. C. A. 2d), involved only the issue of a stockholder's transferee liabil-

ity for the lessor's income taxes. That issue was decided in favor of the stockholder. Apparently the court thought the lessor corporation was constructively in receipt of the payments made to its stockholders by the lessee, but had not constructively transferred them —or, if so, that constructive transfer was not adequate basis for stockholder's liability as a transferee. Escape from the artificiality of the constructive receipt doctrine seems to have been the objective and the attainment of this decision.

The most recent case is *Gold & Stock Telegraph Co.* v. *Commissioner* (83 F (2d) 465; C. C. A. 2d). There the court placed its decision squarely on the ground that "the stockholders remained in receipt of income which came to them, though, under the agreement, because they were not merely promisees or assignees but stockholders still availing themselves of the corporation *to hold title on their behalf*" (p. 467). And so in the companion case, *U. S.* v. *Northwestern Telegraph Co.* (83 F. (2d) 468), the same court said: "We do not think that the stockholders can avail themselves of a corporate organization to avoid the double tax, which is ordinarily imposed where income arises *from the property of a corporation* and is paid to its stockholders, without subjecting themselves to such tax liabilities as may be inherent in the relation." (p. 469.)

In the case at bar, as in the *Gold & Stock Telegraph Co. case* (83 F.(2d) 465), the respondent has neither control over nor interest in the payments made to respondent's stockholders by the Alton Railroad Company. (See *Northwestern Telegraph Co.* v. *Wisconsin Tax Comm.*, 248 N. W. 164, a decision deemed correct but not controlling in the *Gold & Stock case*). Even where the "dividends" are thus beyond the control of the lessor, the cases cited by petitioner may impose income tax

liability on the lessor corporation, but only because that corporation is availed of by the stockholders *to hold title to the property producing the income they receive.*

Since this factor was not present in this case, the court below rightly held that: "The indenture agreement of 1864 did two things—(1) it put the ownership of all the corporate assets, together with any income therefrom, irrevocably out of the hands of the plaintiff and into the hands of the grantee, and (2) it created a contractual obligation in favor of the shareholders, definite in amount, and in their right of enforcement. By this agreement, the shareholders succeeded to all the right which plaintiff might otherwise have had to this income, and, therefore, it is their income and not that of the plaintiff, either actually or constructively." (118 F.(2d) 174, 175.)

The principle to be applied is that liability for tax follows control over income, either direct or indirect. The court below found no such control and therefore did not impose the liability. That conclusion presents no conflict, either of decision or in principle.

We are unable to share petitioner's apprehension as to the practical consequence of the decision below. It is true that under it this respondent is relieved from liability for income tax, but the income involved will still be subject to corporate tax as part of the income of the Alton Railroad Company, and of course will also be taxable to the stockholders. We are surprised at petitioner's suggestion that there are several cases of this character pending. While this respondent and one other corporation standing in substantially the same relation to the Alton Railroad Company, have several cases pending, it has been respondent's impression that there are a very few if any other indentures of the type here involved in the entire country.

CONCLUSION.

It is respectfully submitted that the petition for a writ of certiorari should be denied.

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